

Memorandum

To : Mr. Verne Walton

Date : December 9, 1988

From : *Barbara G. Elbrecht*
Barbara G. Elbrecht

Subject : 35-Year Lease Extensions

This is in response to your memorandum of August 16, 1988 asking whether the extension of a lease with a remaining term of less than thirty-five years to fifty years is a change in ownership. Attached to your request was a letter from Appraiser III, Orange County Assessor's Office, requesting "some direct authority in support of, or in relief from, the practice of reassessing certain leasehold amendments which boost the remaining term over the 35-year mark." states that local assessment appeals boards and a superior court have rejected the assessor's practice of treating as a change in ownership the extension of a leasehold interest with a remaining term of less than 35 years when the extension results in the creation of a new remaining term of 35 years or more. The assessor's practice is based upon our advice letter of July 13, 1981, a copy of which is attached. According to [redacted], "[t]he local bone of contention seems to go beyond the absence of a shift in use, and on to notions of fundamental fairness . . . that a lessee once seized of a reasonable quantum of use and enjoyment (35 years or more) should not be reassessed for grants of additional term, even if they occur at a time when the balance of term outstanding has slipped below the 35 year mark!" The major problem in his view is that Rule 462(f) does not specifically address this issue. [redacted] further states that in "the absence of credible authority to comply with the State Board interpretation of the law, we find ourselves practically bound by local legal interpretations on issue."

As you know, Section 60 of the Revenue and Taxation Code (all section references contained herein are to the Revenue and Taxation Code) states that:

A "change in ownership" means a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest.

Included within the definition of a change in ownership by Section 61(c) is:

(c)(1) The creation of a leasehold interest in taxable real property for a term of 35 years or more (including renewal options), the termination of a leasehold interest in taxable real property which had an original term of 35 years or more (including renewal options), and any transfer of a leasehold interest having a remaining term of 35 years or more (including renewal options); or (2) any transfer of a lessor's interest in taxable real property subject to a lease with a remaining term (including renewal options) of less than 35 years.

Only that portion of a property subject to such lease or transfer shall be considered to have undergone a change of ownership.

These statutory provisions have been interpreted by subdivision (f) of Property Tax Rule 462 which states, in pertinent part:

(1) The following transfers of either the lessee's interest or the lessor's interest in taxable real property constitute a change in ownership of such real property:

(A) Lessee's Interest:

(i) The creation of a leasehold interest in real property for a term of 35 years or more.

(B) Lessor's Interest:

(i) The transfer of a lessor's interest in taxable real property subject to a lease with a remaining term of less than 35 years.

These statutory and rule provisions incorporate the theory of "value equivalence" which has been explained as it pertains to leases in the Report of the Task Force on Property Tax Administration dated January 22, 1979. That report states:

Value Equivalence. The "value equivalence" test is necessary to determine who is the primary owner of the property at any given time. Often two or more people have interests in a single parcel of real property. Leases are a good example. The landlord owns the reversion; the tenant, the leasehold interest. Suppose the landlord sells the property subject to the lease and the lessee assigns the lease. Which sale or transfer is the change in ownership?

The example illustrates that in determining whether a change in ownership has occurred it is necessary to identify but one primary owner. Otherwise assessors would be forced to value, and account for separate base year values for landlords and tenants on all leases, and for other forms of split ownership. This would enormously complicate the assessor's job.

A major purpose of this third element [value equivalence], therefore, is to avoid such unwarranted complexity by identifying the primary owner, so that only a transfer by him will be a change in ownership and when it occurs the whole property will be reappraised. If the hypothetical lease previously mentioned was a short term lease (the landlord owned the main economic value), the landlord's sale, subject to the lease would count. If, on the other hand, the lease was a long term lease (the lessee's interest was the main economic package), the lease assignment would count. In either case the entire fee value of the leased premises would be reappraised. (pp. 39-40.)

This quotation explains the rationale behind the concept of identifying the primary owner of a leasehold interest. It also points out that only a transfer by the primary owner will be a change in ownership.

This statement is consistent with the basic definition that a change in ownership requires a transfer of a present interest. "Transfer" has been defined as "the conveyance of right, title, or interest in either real or personal property from one person to another by sale, gift, or other process" (Webster's New Internat. Dict. (3d ed. 1971) p. 2427).

By statute, when the remaining term of a leasehold interest for a term of 35 years or more falls below 35 years, primary ownership of the leasehold shifts from the lessee to the lessor, as explained above. A change in ownership at that point does not occur, however, because there has been no transfer of that interest. Without a transfer, the real property cannot undergo a change in ownership.

However, when the lessee with a remaining term of less than 35 years extends or enters into a new lease term with the lessor, who is at this point considered the primary owner of the property, a transfer (a conveyance of an interest in property) occurs. If that new leasehold term equals thirty-five years or more, a change in ownership has occurred under Section 61(c) and Rule 462(f). Neither the statute nor the rule implies in any way that possession of the leasehold is to be considered in determining if a change in ownership has occurred. Thus, issues of fundamental

fairness or the absence of a shift in use are totally irrelevant. The statute and rule state clearly that the creation of a leasehold interest in real property for a term of 35 years or more is a change in ownership.

states that in the absence of "credible authority" supporting our interpretation, the assessor's office finds itself "practically bound by local legal interpretations on issue." We are not aware of any authority that states that assessment appeal decisions in particular appeals are binding upon the assessor in any other assessment appeals, even though the issues may be similar. Moreover, a superior court decision merely resolves the controversy before it; its decision does not provide precedent that must be followed in any other dispute. It is unfortunate that the assessor's office did not chose to appeal the superior court decision; if it had, it could have obtained a court of appeal decision which would have provided the authority they are seeking.

The only case we are aware of which deals with Section 61(c) is E. Gottschalk & Co. v. County of Merced (1987) 196 Cal.App.3d 1378. In upholding the constitutionality of Section 61(c), the court stated that it gave "great deference to the Legislature's determination that a lease of 35 years is substantially equivalent to the value of the fee" (Gottschalk, at p. 1386). Since the court has specifically upheld the constitutionality of Section 61(c), and the statute and regulation indicate that the creation of a leasehold term of 35 years or more is a change in ownership, we see no reason to change the opinion set forth in the letter of July 13, 1981.

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Attachment

cc: Mr. Richard H. Ochsner - w/att.
Mr. Robert H. Gustafson - w/att.

July 13, 1981

This is in response to your letter of May 26, 1981, to Mr. James Delaney regarding the extension of leases for purposes of change in ownership.

Generally, it is our opinion that the assessor should initially look to the original term of the lease including written renewal options. If that original term is for at least 35 years, then there is a change in ownership of the property upon the creation of the lease. Conversely, if the term is for less than 35 years, then there is no reappraisal upon the creation of the lease. However, if before the lease term is expired it is renewed or extended, it is our opinion that the remaining term of the lease should be reviewed to see if the lessor or the lessee is statutorily considered to be the owner of the property. If the remaining term is less than 35 years, then the lessor is technically considered to be the owner; if the remaining term is 35 years or more, then the lessee is considered to be the owner. Therefore, we believe that only in the situation where: (1) the remaining lease term at the time of renewal is less than 35 years and (2) the remaining term plus the renewal term is for at least 35 years, is there a change in ownership of the property and a reappraisal required.

Example 1. Original term of the lease is 10 years. (No change in ownership upon creation.) With 9 years remaining the parties agree to extend the lease for 27 more years. (Lessee will be in possession for another 36 years.)

In the above example, the lessor is considered the owner of the property and a transfer of his interest would constitute a change in ownership (Section 61(c)(2)). At the time he agreed to extend the lease for 27 more years (for a total term of 36 years), he effectively made the lessee the owner of the property. Therefore, there is a reappraisal of the property at the time the extension agreement was executed.

Example 2. Original term of the lease with renewal options is 50 years.

(There is a change in ownership upon the creation of the lease.) With 49 years remaining the parties agree to extend the lease for another 10 years.

In this example, upon the creation of the original lease, there was a change in ownership and the lessee is considered to be the owner for property tax purposes. Similarly, when the lease is renewed, the remaining term of the original lease is 49 years and the lessee is still considered to be the owner of the property, so there is no change in ownership upon renewal. On the other hand, if the agreement is executed when there is only one day remaining on the original term, the lessor is considered to be the owner. However, since the renewal is for 10 years (thereby making the lease term upon renewal 10 years and one day), there is no change in ownership. A reappraisal does occur at the end of the period, since it is a termination of a leasehold interest which had an original term of 35 years or more (Section 61(c)(1)).

In your letter you point out that the term "renewal" is included in Section 61(b) of the Revenue and Taxation Code (possessory interests) but does not appear in Section 61(c) (leases). With respect to possessory interests, the holder of the interest is always considered the owner of the property regardless of the term of possession. In regard to leases, on the other hand, the term of possession is the key in determining whether a change in ownership occurs. When a term is created, the length thereof is calculated with regard to renewal options. In the event that a renewal option is not created concurrently with the creation of the leasehold, then it is our opinion that at the point in time that there is an actual renewal or extension of the lease (whether it is specified to take effect upon execution of the agreement or upon termination of the original lease term) that a new lease term is

created for property tax purposes. This new lease term (the remaining term of the original lease plus the term specified in the renewal agreement) is then measured against the statutory 35-year test, to ascertain who is considered to be the owner of the property. If both before and after the execution of the renewal agreement, the lessee is considered to be the owner, then there is no change in ownership upon the renewal or extension of the original lease.

Accordingly, we believe that the fact the lessee is already in possession is not necessarily determinative of the issue of whether a change in ownership has occurred. Rather, it is the length of the remaining term of the original lease at the time of renewal and the renewal term plus the remaining term that are decisive in the determination of who is considered to be the owner of the property.

Very truly yours,

Margaret S. Shedd
Tax Counsel

MSS:jlh